London-based carbon fund dips toe in UK ETS as new market attracts more interest

Published 15:50 on June 14, 2021 / Last updated at 15:50 on June 14, 2021 / Americas, Bavardage, Canada, Conversations, EMEA, EU ETS, International, UK ETS, US / No Comments

A London-based carbon fund has made its first investment in the UK's nascent emissions trading scheme, as interest from non-compliance players builds.

Carbon Cap Management, whose World Carbon Fund invests in allowances from the world's largest carbon markets, said it has placed "its first small trades" in the UK ETS last month, according to an email update seen by Carbon Pulse.

The company declined to provide further details, but it joins a number of other firms that are starting to take positions in the small, illiquid market.

Carbon Cap said its flagship fund saw positive returns from its two investment strategies in May, translating into a 2.2% return for the month after posting a 4.9% gain in April.

"Within the 'Core Long' strategy, we are maintaining our overweight position in the US carbon markets relative to EUA and UKA carbon, reflecting our fundamental supply/demand modelling," the firm said.

"With EUA and UKA carbon now trading at approximately $65 per tonne and the CCA and RGGI carbon markets priced at $20 and $9 per tonne, our valuation models indicate that the US carbon markets represent better value and a better risk/reward over the next 6 to 12 months," it said, adding that rising inflation in the US will help lift California carbon prices.

Carbon Cap said it sees a UKA premium over EUAs as warranted, but not at levels above €5 – where the UK market was trading last month following its launch – because there is a strong possibility that the two schemes will be linked in the future, which should introduce price parity.

The World Carbon Fund was down 0.13% for the year to date as of May 31, after climbing 9.46% in 2020.

Carbon Cap will seek to further increase those returns through its positioning in the UK ETS, which it noted “takes the title of the most expensive compliance carbon market in the world”.

INTEREST BUILDING

Since trading launched on ICE Futures Europe May 19, the front-year UKA futures have traded down as low as £45.10 on their first day, to a high of £51.75 a week later.

The benchmark contract has since eased back to the £46-48 range, though volumes have been steadily picking up as supply increases and confidence amongst participants builds.

Turnover on the Dec-21 UKA futures has increased by 15% to over 480 lots/day so far this month compared to last, ICE data shows.

As well, trading data from the exchange indicates that for the week ended June 4, an undisclosed number of investment firms had collectively built a long UKA futures position of 500,000 tonnes.
That was nearly five times the 105,000-tonne long position reported by all participating funds at the end of the market’s first week of trading.

Open interest on the Dec-21 UKAs was just under 3.1 mln as of Friday.

ICE’s weekly Commitment of Traders data also showed a 1.3-Mt net long position built by commercial undertakings as of June 4, as well as 37,000 tonnes worth of futures bought by compliance players.

Financials were shown to be net short 935,000 UKAs, based on an overall 216,000 tonnes in longs and 1.15 Mt in shorts, with a majority of this thought to be hedges against physical holdings.

However, some traders are showing some reluctance towards opening UKA positions, at least until liquidity improves further and there’s more clarity on future supply.

The UK government last month said it may increase the amount of allowances to be sold at auction in 2021, after this year's free allocation quota was nearly 20 Mt less than initially expected.
What's more, UKAs continue to trade above the trigger level for the country's Cost Containment Mechanism (CCM), which is tasked with controlling excessive price rises.

Unless the benchmark futures retreat considerably from current levels over the next month-and-a-half, signs are pointing to policymakers convening in early August to discuss supply-side intervention.
CONSULTATION

Separately, the British government on Monday launched a consultation on the risk of carbon leakage due to indirect emissions costs from the UK ETS and the country's carbon price support mechanism, which has been in place for nearly a decade and which currently includes a £18/tonne CO_2 tax on the power sector that is applied top of any cap-and-trade costs.
This consultation seeks views and evidence on the current compensation scheme in place to address this, which was last year extended by one year in order to allow time for a review.

The government said it will help determine which sectors are most at risk from foreign competition, and how the compensation programme might be altered if the rationale to maintain it exists.

The consultation will run until Aug. 9.

Check out Carbon Pulse's Guide to the UK ETS
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